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SUBJECT: Argentina's Growing Trade Deficit with Brazil Spotlights
Uncompetitive Argentine Industrial Sector

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SUMMARY

¶1. (SBU) President Lula's August 3-4 visit to Argentina has focused attention on Argentina's 62-month-long string of bilateral trade deficits with Brazil. Brazil is Argentina's number one trading partner and this bilateral merchandise trade deficit, up 47% y-o-y to US$ 3 billion in just the first six months of 2008, stands in stark contrast to Argentina's agricultural commodity-driven global trade surplus, which totaled nearly US$ 11.1 billion in 2007 and US$ 5.1 billion in the first half of 2008. In 2007, Argentina sent 19% of its merchandise exports to Brazil and received 32% of its imports from Brazil. 2007 trade in goods with Brazil totaled more than Argentina's combined trade in goods with its next three trading partners (China, U.S., Chile). The enormous growth in Argentine imports of Brazilian manufactured goods, despite a 60% appreciation of the Brazilian real vis the Argentine Peso since July 2003, speaks volumes about the relative lack of competitiveness of Argentina's manufacturing sector. Local economists attribute Argentina's uncompetitive industrial base to uncertainties created by frequent GoA economic intervention, a shortage of long-term public sector credit, an appreciating real exchange rate since 2003, outdated infrastructure, particularly in transportation and power, and inadequate investment in new infrastructure.
END SUMMARY.

62-MONTH-LONG TRADE DEFICIT WITH BRAZIL

¶2. (SBU) Brazil, the 11th largest economy in the world, is Argentina's number one trading partner. In 2007, Argentina sent 19% of its merchandise exports to Brazil and, in turn, received 32% of its imports from Brazil. 2007 Argentine bilateral trade in goods with Brazil totaled US$ 25.0 billion, more than Argentina's total trade in goods with numbers two through four (China, U.S., Chile - US$ 10.3, US$ 9.7, and US$ 4.9 billion, respectively) combined. In 2007, total merchandise imports from Brazil reached US$ 14.5 billion, up 24% since 2006, 88% since 2004, and 209% since 2003. Argentina's exports to Brazil reached US$ 10.5 billion in 2007, up 29% since 2006, 87% since 2004, and 125% since 2003. Imports of Brazilian products have risen at a faster pace than the increase in Argentine exports to Brazil every year since 2003 and Argentina has sustained a growing trade deficit with Brazil for the past 62 consecutive months. This bilateral trade deficit stands in stark contrast to Argentina's global trade surplus, which totaled nearly US $11.1 billion in 2007 and US $5.1 billion in the first half of
¶2008.

¶3. (SBU) During the first six months of 2008, Argentina's trade deficit with Brazil continued to rise and reached US$ 3.0 billion, 47% higher than the same period in 2007. The June deficit of US$ 666 million (US$ 1.6 billion in Brazilian imports versus US$ 941 million in Argentine exports) was a 92% increase over June 2007. Maximiliano Scarlan, an analyst at a Buenos Aires economic consulting firm, told Argentine press July 2 that the growth in the bilateral trade deficit, can be attributed to recent Argentina's export restrictions on wheat (Ref B and see para 7), and GoB encouragement of its export sector by providing soft national development bank (BNDES) credits to firms that expand internationally. GoA Economy Ministry officials and Argentine business leaders have long complained to Econoffs that such BNDES credits represent an effective subsidy to Brazilian industry that places Argentine industry at a comparative disadvantage.

ARGENTINA'S MERCOSUR TRADE A FOOTNOTE TO BILAT BRAZIL TRADE

¶4. (SBU) Total Argentine trade within the Mercosur bloc has grown 154% since 2003 (imports grew 151% while exports grew 156%) In 2007, Mercosur trade accounted for 36% (or US $16.0 billion) of Argentine imports and 22% (or US $12.4 billion) of its exports (Note: Argentina's trade with Brazil makes up 88% of its total Mercosur trade.) Brazil and Argentina, the only auto producers in Mercosur (not including Venezuela, whose full membership is pending approval), have substantial auto and auto parts trade under a managed trading system. In 2007, auto sector trade made up 18% of total intra-Mercosur trade, and Argentina-Brazil auto product trade in 2006 totaled over US $4 billion. According to many observers, the managed trade auto pact has played a fundamental role in sustaining Argentina's support for Mercosur over the years.

AUTOMOBILES PROPEL TRADE GROWTH

¶5. (SBU) The dramatic rise in Argentine imports from Brazil (a 209% increase since 2003) is due primarily to expanded imports of vehicles (30% of total imports, a 24% increase from 2006 and 341% increase from 2003); machinery, reactors, boilers (12% of total, a 25% increase from 2006 and 211% from 2003); electrical machinery (10% of total, a 11% increase from 2006 and 390% from 2003); plastic (6% of total, a 26% increase from 2006 and 162% from 2003); and iron and steel (5% of total, a 26% increase from 2006 and 298% from 2003).

¶6. (SBU) Argentine exports to Brazil have increased at a slower pace than imports, rising 125% since 2003. Higher exports are led by vehicles (29% of total, a 57% increase from 2006 and 450% increase from 2003); oil (16% of total, a 21% increase from 2006 and 83% from 2003); cereals (12% of total, a 24% increase from 2006 and 40% from 2003); plastic (6% of total, a 4% increase from 2006 and 72% from 2003); and machinery, reactors, boilers (4% of total, a 31% increase from 2006 and 78% from 2003). While all of the top five Argentine imports from Brazil are manufactured goods, including vehicles, machinery; reactors/boilers, electrical machinery, and iron and steel, commodity exports account for the single largest share of Argentine exports to Brazil, some 28% of total exports. Imports from Brazil also include a significant share of capital goods, which have helped fuel strong growth in Argentina's industrial and agricultural sectors in recent years.

ARGENTINE WHEAT EXPORTS TO BRAZIL DECLINE

¶7. (SBU) Since November 2007, GoA restrictions on wheat exports (Ref B) have led Brazil to source wheat from other countries, including the U.S. and Canada. However, since Brazil typically relies on Argentina for 80% of its annual wheat imports, analysts predict that Brazil will return to Argentina for wheat once supplies are available and that the GoA's restrictive policies will not trigger a long-term change in Brazil's buying habits. (Brazil was a significant buyer of U.S. wheat until the formation of the Mercosur trade bloc in 1991, which allowed grain to move between member

countries duty-free.) As of late May, Argentina had exported 3 million tons of its 2007-2008 wheat crop to Brazil, far short of the 5.1 million tons normally exported to Brazil each year. Since wheat is Argentina's number three export to Brazil (making up 11% of total 2007 exports), restricting wheat exports contributed significantly to the increase in Argentina's bilateral trade deficit in the first half of 2008.

PLAN TO TRADE IN LOCAL CURRENCIES

¶8. (SBU) Argentina and Brazil's Central Banks have announced they will implement a new bilateral payment system in September 2008 to enable the countries to trade bilaterally in their own currencies, rather than the current method of trading in U.S. dollars. Under the announced system, there will be a unified exchange rate between the real and peso, the so-called "reference rate," which will be applied by the countries' central banks at the end of each day. On June 26, the GoA's Official Gazette published Executive Order 1003/2008, stating that the plan seeks to "deepen regional integration, increase the exchange of goods, and reduce financial costs among its members." On June 27, Brazilian Finance Minister Guido Mantega told Argentine press that the new payment system will reduce transaction costs and benefit small and medium size businesses. The first stage of the plan includes only Brazil and Argentina, the largest of the four Mercosur members, but could be expanded to include Uruguay and Paraguay. The Venezuelan government has expressed interest in this initiative. However, it is unclear whether Venezuela's request to participate in the new payment system will be permitted given that its full Mercosur membership is pending approval by the Brazilian and Paraguayan parliaments.

COMMENT

¶9. (SBU) The enormous growth in Argentine imports of Brazilian manufactured goods, despite a 60% appreciation of the Brazilian real against the Argentine Peso since July 2003, speaks volumes about the relative lack of competitiveness of Argentina's manufacturing sector. Local economists attribute Argentina's un-competitive

industrial base to uncertainties created by frequent GoA economic intervention, a shortage of long term public sector credit, an appreciating real exchange rate since 2003, outdated infrastructure, particularly in transportation and power, and inadequate investment in new infrastructure. Argentina's industrial sector also lacks the scale provided by Brazil's large domestic market (with 4.8 times the population and five times the GDP) which offers Brazilian industry substantial production economies of scale.

¶10. (SBU) While GoA officials openly complain that soft public development bank (BNDES) financing for its exporters offers Brazilian industry an unfair competitive advantage, the Brazilians reasonably note that Argentine domestic energy subsidies, which leave electricity and natural gas prices a fraction of those in Brazil, offer unfair advantages to Argentine producers.

¶11. (SBU) Brazilian President Luis Inacio Lula da Silva on May 12 announced Brazil's 2008-2010 Program of Productive Development, defining the country's economic goals and how they will be achieved. The program's primary objectives are to position Brazilian firms and production systems among the five largest world players, to become one of the principle exporters of durable consumer goods and capital goods, to specialize in areas of high density technology, and to strengthen Brazilian brand names in the world market. In contrast to Brazil's well-articulated industrial development policy, many economic analysts here argue that GoA industrial sector economic planning remains ad hoc and consummately protectionist. Industrial sector contacts at the August 4 Brazil-Argentina trade and investment conference in Buenos Aires (Ref A) commented to Econoffs that Argentina has much to learn from Brazil, and they hope Argentina learns it soon, before Brazilian competitors buy out their firms! On the other hand, a top Argentine banker recently told Ambassador that the presence of Brazilian firms in Argentina is having the positive effect of generating more attention to long-term strategy, in contrast to the very short-term focus of many Argentine

business leaders.

¶12. (U) Septel will analyze the products involved in the bilateral trading relationship in greater depth.

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